



## **BUDGET ADDRESS OF GOVERNOR DENNIS DAUGAARD**

THE STATE CAPITOL – PIERRE, SOUTH DAKOTA – DECEMBER 5, 2017

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Thank you, and thank you for that moving tribute to our good friend Craig Tieszen.

I know we were all shocked when we heard the news about Craig. As so many of you voiced so eloquently, he was a consummate public servant. From the Peace Corps, to his long service in law enforcement, to our friendship with him and his service as a legislator. He never let his preconceived notions get in the way. He was always a good listener, a good debater, respectful always. He took his time to make the best decision. We are going to be missing him but he is a great example to us all.

My duty today is to offer a proposed budget for Fiscal Year 2019. In today's speech, I will review the state's economy, the current year revenues and expenses, and offer my proposals for next year.

The Bureau of Finance and Management releases monthly revenue updates on its website every month. If you follow those, you know that the state's revenue collections have not been meeting projections for the year we're in right now. Today, I will propose expense reductions and one-time revenue to bridge that gap. But despite that weakness in revenue, revenue is still growing, albeit slowly. And by next June, at the end of the fiscal year, we should have enough revenue growth to structurally balance the Fiscal Year 2019 budget.

But let's begin with a look back over the past year to see the challenges that we have already overcome.

Fiscal Year 2017 was challenging because of weak revenue. Then as well, we had to revise our revenue estimates down as we moved through the fiscal year.

The adopted revenue estimate seen here was just short of \$1.6 billion of projected revenue. That was adopted in February of 2016, several months before the fiscal year even started.

Then a year ago in December at this speech, I proposed a downward revision of about \$12 million lower as revenue was less than projected for Fiscal Year 2017.

Then, last March, when you convened, the legislature adopted a revenue estimate which was lower by still ANOTHER \$22 million (\$22.3 million).

And then, when we finally closed the book in 2017, actual revenue was lower by still another \$7.6 million. All told, compared to the original adopted estimate, we had stair-stepped down a total of \$42 million. Fortunately, we were able to balance the budget through reduced spending.

This next chart adds all the expense levels for each iteration of the FY2017 budget, which is represented by the red bars. You can see, each time our revenue estimate was lowered, we cut expenses to maintain balance.

And as we approached year-end, seeing continued revenue weakness and uncertain where revenue would ultimately land, I directed executive branch agencies to cut spending still more, resulting in a \$7.9 million budget surplus at fiscal year end.

The surplus was deposited, as was required by law, into the budget reserve fund.

Let's talk about budget reserves.

South Dakota is very prudent about using budget reserves, and we can be proud of that. When we talk about budget reserves funds, I'm really talking about the combined balance of two funds: The budget reserve fund, that's the technical term for it, and the general revenue replacement fund. Combined, those are our reserves. This chart shows the balance of those reserve funds as a percentage of our budget over the past 10 years. As you can see, from FY2009 through FY2011, during the recession years, we had a little over 9% in reserves.

Since then, we've maintained reserves at or above 10% of our general fund appropriations. Nationally, for perspective, the median state budget rainy day fund balance is about 6%, with half the states above that, and half the states below.

Our policy has been to maintain a combined balance of those two accounts equal to 10% of general fund spending. And when our reserves have been in excess of 10%, we have used the extra for one-time expenses, such as debt reduction.

Today we have \$165.3 million in reserves or about 10.5%. My recommendation for FY2018 is to use that portion beyond 10% to help cover our current year shortfall, specifically for education funding. I'll explain more about that in a minute, but first, let's take a look at some economic trends.

The Bureau of Finance and Management and the South Dakota Council of Economic Advisors regularly review a wide range of economic indicators which are used to forecast future tax revenue. Reviewing this information with economic experts from across the state helps us provide the best economic and revenue forecast for the budget each year.

Let's take a look at some of those economic forecasts.

First, let's look at national forecasts. The Council of Economic Advisors and our BFM staff look at national forecasts from a consultant as a baseline to provide a revenue forecast for the major sources of revenue such as the sales tax. IHS Markit is our primary consultant that produces a monthly national economic forecast.

The most recent national forecast from IHS Markit is that the real GDP growth from the United States will grow 2.4% in 2018 and 2.2% in 2019.

The South Dakota economic forecast is a little more conservative, which is consistent with the views of the Council of Economic Advisors. This South Dakota forecast was used to develop the revenue projections that I'm presenting to you today. We expect positive economic growth, but need to be cautious given recent sluggish revenue growth.

Inflation is another important variable, because inflation has a direct impact on the growth of our sales tax. Higher inflation creates stronger growth in sales tax revenue, but lower inflation as we've experienced the past several years, leads to slower growth in sales taxes. Inflation is anticipated to be in the 1.7-2.2% range over the next two years, slightly stronger than in recent past, but still less than historically seen.

The forecast assumes no economic recession nor a major disruption from abroad.

And it also assumes steady housing and construction activity over the next two years.

Finally, as you know, agriculture is a major cornerstone of our state's economy. Drought conditions in much of the state this growing season exacerbated the impact of low prices, which will likely result in the fourth year of declining farm income since 2013. The forecast projects that calendar year 2017 will be near a low in terms of farm income, with perhaps some marginal improvement in calendar year 2018 if normal production levels return. This, of course, can depend on the weather as well as federal trade policy.

These charts show more recent forecasts by IHS Markit for the US economy using four key indicators. The grey bars show calendar year actual figures and the blue bars are the forecasts.

The first chart, top left, shows US Real Gross Domestic Product in trillions of dollars. Real GDP is considered the most comprehensive measure of the US economy. Real GDP has realized steady growth since the recession ended. IHS Markit forecasts more than \$17 trillion of real GDP in 2018 and 2019, at growth rates of 2.4% and 2.2%, respectively. I mentioned that earlier.

The top right chart shows US employment. Job growth is forecast at 1.3% for 2018 and 1.1% for 2019.

The bottom left chart shows millions of US housing starts. In 2017, housing starts have been flat, but they are anticipated to grow at a steady pace in 2018 and 2019.

The bottom right chart shows the US inflation rate. Over the past four years, we have experienced low inflation, almost zero in 2015. Inflation in 2018 and 2019 is predicted to increase 1.7% and 2.2% respectively.

Next, let's consider four South Dakota specific economic indicators - employment, nonfarm income, housing starts and unemployment.

Again, these forecasts are for South Dakota's **economy** and were used to project revenue for FY2018 and 2019. Remember, these forecasts from IHS Markit were adjusted to be more conservative, consistent with the Council of Economic Advisors views.

First, let's look top left, South Dakota employment. During the recession, South Dakota did realize job losses, but only at about half the rate of the US economy. We recovered those jobs more quickly than the nation. In recent months, our employment growth has slowed, and we anticipate continued slow growth in both 2018 and 2019.

The chart on the top right is South Dakota nonfarm income. South Dakota nonfarm income is forecast to grow 3.3% and 3.8%, in 2018 and 2019, lower than historical growth rates.

Bottom left is South Dakota housing starts. Housing starts have been down as you can see in 2017 compared to an unusually strong year in 2016, but are expected to be at healthy levels in 2018 and 2019 of around 5,000 housing starts.

The last chart, bottom right is South Dakota unemployment. After levels of 5% or worse during 2009 and 2010, South Dakota unemployment declined to a low of 2.8% in 2016. So far, it's increased slightly to 3.5%, but we anticipate it will average 3.1% on an annual basis over the next two years.

The bottom line: The moderated forecasts indicate a cautious outlook for the South Dakota economy. We should continue to be conservative in economic and revenue forecasts as in the past.

Now when we look at general fund revenues, we must remember that Sales and Use taxes make up nearly 63%, it's our largest revenue source by far. It can be volatile, month-to-month, and it's important to track sales taxes as we make budget decisions.

Let's look at some trends we have been seeing in the sales tax base.

This is taxable sales now. This chart tracks monthly taxable sales – not the sales tax but the taxable sales upon which the tax is levied. It shows about 120 months of history back to 2007. It has been smoothed using a 12 month moving average.

You can see from 2012 through 2014, we experienced steady growth, but growth has been slowing since 2015. You can notice on the right side of the chart, the past three years, we have been nearly flat. Later, we will talk about reasons why our sales tax has been sluggish recently.

Let's look at it on an annual basis. This chart, again, shows taxable sales by fiscal year. In normal years, we can expect some growth. Notice that FY2011, for example, had very strong growth. FY2014 had strong growth. 2015 and 2016 had slightly more taxable sales, and we actually had a decrease in taxable sales in FY2017.

Let's look at some recent monthly data to see how our sales tax has performed in recent months.

This chart shows the most recent 16 months of sales tax growth rates, measured on a year-over-year growth rate. The months in 2017 were adjusted to remove the impact of the half penny sales tax so it would be an apples to apples comparison.

As we saw earlier, FY2017 was a challenging year, with 8 of 12 months showing lower tax collections than the previous year, even after adjusting.

In a more recent month we've seen some improvement, but looking at the far right side of the chart, you can see the 4.0% growth is the line. We need that growth on average to meet our Adopted FY2018 sales tax estimate.

The added red line shows the year-to-date growth as it progressed each month. So in FY2017, you can see we finished the year with a decrease for the year of 1.6%. Remember, for comparison purposes, again, FY2017 growth rates were adjusted to remove the half penny. So comparing 4% to 4%, we actually collected less sales tax in FY2017 than in 2016.

Through the first four months of FY2018, we are up 2.3% compared to a year ago. It's certainly good to see the sales tax has improved in 3 out of 4 months, but we are still a little bit below the adopted growth rate needed of 4.0%.

And so what we're doing now we've added a revised growth rate of sales tax that I am recommending to you today. It is revised down to 3.0%, about 1.0% lower than the original adopted estimate. That's the FY2018 projected revenue as adjusted.

We showed this chart previously with just history of taxable sales. Now at the right, we have added the estimated 2018 taxable sales that are shaded in the far right column.

You can notice a slight improvement from 2017, which represents the revised 3% growth, but still relatively flat as compared to the previous three fiscal years.

Before we cover the revenue forecasts, let's discuss some reasons why our sales tax has been soft in recent years.

What are some of the factors that are contributing to sales tax weakness?

First, low farm income. As we've mentioned before, farm income has been lower, leading to lower spending, both directly and indirectly in rural areas of the state.

Second, low inflation. As another factor, low inflation that we've experienced over the past several years has limited the growth in our sales tax base.

As a third factor, e-commerce. Continued growth of e-commerce spending continues to be a concern, because sales tax is not being collected on a portion of these sales by out-of-state businesses.

Finally, the ever increasing cost of health care in our country is crowding out income and spending; especially discretionary spending, that could be spent on taxable goods and services.

And now I'd like to look at each one of these four factors a little more closely.

First, farm income. Agriculture, of course, plays a very important role in South Dakota's economy.

The blue bars, measured against the left hand numbers in blue, show South Dakota net farm income on a calendar year basis. These are calendar year blue bars. Look at 2002, 2006, and 2012. You can see the income drop during those drought years. Look at 2008 and later. Income is strong, with high crop prices and big harvests in most years. Calendar year 2012 was a drought year, but crop insurance locked in spring prices which were still high. From calendar year 2014 to 2016 farm income dropped each year.

And in 2017 calendar year, income is expected to be lower yet again due to drought conditions and continued low crop prices.

So what does this mean for our budget? Of course, there is a significant indirect impact, as lower farm incomes mean less spending in all sectors of our economy. The most direct impact is on sales tax receipts on farm machinery. And as you know, in South Dakota, many purchases by Ag producers are exempt from sales tax, but sales and use tax does apply to farm machinery.

The red line defined by the red numbers on the right, estimates farm machinery sales tax collections. And this is fiscal year data. Look at 2007 and later. Tax incentives and strong farm income fueled strong machinery purchases.

Sales taxes grew from \$17.4 million in FY2008 to nearly \$45 million in FY2014. This boosted our tax revenue during those years and helped our economy through the recession.

But today we see fewer farm machinery purchases and less sales tax, consequently. Since the peak in 2014, fiscal year 2014, sales tax on machinery has dropped more than 50%. Lower net farm income means less farm machinery sales taxes.

Next, let's look at the second factor - inflation.

This graph shows annual inflation rates as measured by the Consumer Price Index, excluding housing and rent prices. We don't pay sales taxes on rent, we don't pay sales taxes when you make a mortgage payment or buy a house. This is national data, by the way, and because changes in housing prices do not have a direct impact on the South Dakota sales tax base those prices have been excluded. So these bars more closely reflect the price change in our sales tax base.

From 1997 through 2012, you can see this index averaged 2.3% growth per year. But with everything else held constant, price inflation contributes to sales tax growth with consumers purchasing the same volume of goods and services – at higher prices, they'll pay higher taxes.

But now look at the far right, the past four years. From 2013-2016, this same index has only increased 0.3%, three-tenths of 1%, on average. Low inflation means lower growth in our sales and use tax collections, certainly one of the reasons why our sales tax base has experienced slower growth in recent years.

Now let's look at the third factor I mentioned: e-commerce.

This chart shows the growth of United States Retail E-Commerce as published by the Census Bureau since the year 2000. These are quarterly figures and most recently in the 3<sup>rd</sup> quarter of 2017, e-commerce sales totaled \$115.3 billion nationwide, representing 9.1% of total retail sales. Remember that 9.1% of total retail sales. In recent years, e-commerce sales have been increasing at a rate in excess of 15%, year over year jumping 15%. But today still, collectively, about 9.1% of total retail sales.

So let's put that in perspective. This chart has the same data, but the scale has been modified and we've stacked the bar to show total retail sales and that 9.1%. So the \$1.3 trillion total sales, e-commerce is \$115.3 billion or about, as I said, about 9% of the total.

The point is, while e-commerce activity continues to grow, 9% is still a relatively small percentage of total retail sales in the United States.

But what about South Dakota? A question we continue to analyze is how much in taxes does South Dakota lose from e-commerce sales?

This pie chart first reminds us that in South Dakota, we have a very broad sales and use tax on most goods and services. E-commerce sales of goods may be rapidly growing but e-commerce services, not as much.

You can't get a haircut online, you can't get your car repaired online. Many services are likely still being taxed; meaning one-third of our sales tax base is probably not as vulnerable to e-commerce losses.

Focusing on the taxable goods then, what share in South Dakota of goods are purchased via e-commerce? It's a difficult question to answer. If we assumed 9% from the national retail sales figures, it would be about less than 6% of our total sales tax

base, as our tax base as I mentioned includes services. In other words, 9% of that 63% in yellow represents less than 6% of the total.

Another question we have to ask is: How much of that is already taxed and captured today?

We know many online sellers like Amazon are voluntary payers, in support of the streamlined sales tax initiative and others were encouraged by Senate Bill 106 from the 2016 Session. So some out-of-state sellers are volunteering their sales tax.

We also know some retailers in South Dakota that have South Dakota stores also have significant e-commerce; stores like Walmart, BestBuy, and Cabela's. They are remitting all the sales tax on e-commerce and in-store sales as well. The problem is some of them file a combined tax return and they don't show how much is from the e-sales and how much is from in-store sales, so it's hard to know exactly how much tax is related to e-commerce versus traditional retail for those sellers.

The point is we know some companies are still not remitting tax, but the amount is hard to know. We previously estimated a \$50 million loss of state and municipal sales taxes but we continue to analyze the amount of this loss as we fight the e-commerce battle through the court system.

The last factor, the fourth factor that I mentioned earlier that I'm going to talk about is healthcare spending.

This graph shows the percentage of total South Dakota consumer spending which is health care spending, as measured by the Bureau of Economic Analysis.

This is not spending by state government; this is spending on outpatient services and hospital and nursing home services by consumers.

It also does NOT include spending on health insurance. It's just spending by consumers directly on those costs. Health insurance premiums have been going up, but that's not included on this chart.

In 1997, you can see South Dakota consumers spent about 15% of their total spending on health care costs; about \$2.1 billion.

On the far right, by 2016, that percentage had increased to 20.5%, a shift of 5.5% of additional spending on health care over the past 20 years.

The change means South Dakota consumers are spending \$1.85 billion on health care, which is not taxable, instead of taxable goods or services. If that \$1.85 billion was being spent instead on taxable goods and services that would equate to more than \$80 million in state sales tax today. So the increase in healthcare spending has eroded the sales tax base.



Now with that background on economic conditions and on the sales tax, let's look at the full revenue picture in dollars, including the revisions for the current year - fiscal year 2018 - and estimates for the budget year, fiscal year, 2019.

In this chart see the adopted FY2018 column. This was our ongoing revenue forecast adopted last March for this year, 2018 fiscal year. The adopted fiscal year total was as you can see was \$1,590.1 million at the bottom of that first numerical column; the next column shows today's revised projection and the last column shows our total ongoing revenue projection is down \$20.3 million.

Sales and Use tax is revised lower by \$9.7 million; we discussed at length some of the weakness we have seen recently.

Lottery has been revised higher slightly by \$0.1 million; this includes instant, online, and video lottery receipts to the general fund. Video lottery is currently running 4.0% higher than a year ago.

Contractor's Excise tax has been revised lower by \$7.9 million. So far this fiscal year, we've been lower compared to very strong collections a year ago. We still anticipate healthy housing and construction activity, but just not at the level that was originally budgeted.

Insurance Company Tax is down \$6.1 million as collections finished 2017 lower than anticipated. We can expect growth compared to a year ago, just less than was adopted.

The remaining revisions roughly offset one other.

Total ongoing receipts are \$1 billion, 569.8 million, which again is \$20.3 million lower than adopted last March.

Remember this \$20.3 lower figure; we'll talk again about this in a minute.

But let's talk about FY2019 projected revenue.

Just add a column. This chart adds that FY2019 ongoing receipts column. The far right column shows the change, in millions, as compared to the FY2018 adopted estimate.

Sales and Use tax, starting on the left, \$989.0 million was the adopted FY2018 estimate. \$979.3 million is the revised estimate today. For FY2019, I recommend a forecast of \$1,016.9 million. The increase of \$27.9 million shown on the far right column compared to, again, the FY2018 adopted figure. This represents how much new sales tax we'll have for new FY2019 expenses.

Lottery, you can see, is projected to grow \$3.3 million. The next three revenue sources in the right column, you'll see, we're being cautious with our projections, forecasting a decrease in contractor's excise tax, insurance company tax, and unclaimed property, as measured against the FY2018 adopted figure.

Licenses, Permits, and Fees estimate is up \$4.9 million dollars, primarily normal growth in security fees.

Other ongoing receipts growth of \$4.4 million includes transfers to the general fund from the South Dakota Housing Authority and the State Veterans' Home operating fund.

In total, for FY2019, I'm proposing a revenue forecast of \$1 billion, 622.5 million. This is \$32.4 million higher than the adopted FY2018 forecast, meaning again, we have \$32.4 million in new ongoing revenue in FY2019.

Now against that \$32.4 number, against the \$32.4 number, let's consider proposed expenses.

First, an overview.

Due to lack of revenue growth, I cannot recommend inflationary increases at all for education or Medicaid providers, or for state employee salaries.

My budget does include the following increases:

For education, I'm proposing funding tied to increased student enrollment.

For Medicaid providers, two years ago, you'll recall we began a plan to move community-based providers' rates to at least 90% of their actual costs over three years. We've been working toward that and this year I'm recommending funding to complete that plan.

And then thirdly, for state employees, although I'm recommending a 0% salary increase across the board, my proposal does include funding to keep some employees' compensation from falling further behind the market. I'll explain more in detail about that later.

Let's take a closer look at the dollar costs of these overall recommendations.

For Education, total dollar increases of \$20.3 million.

Medical Services and Provider Assistance total increases of \$11.3 million.

Protecting People is \$2.6 million.

State Employees at Minimum amount is \$630 thousand.

Title XIX Medicaid FMAP Savings is actually a benefit to lower expenses of \$9.8 million.

Miscellaneous increases and decreases of \$2.4 million.

And Building South Dakota I'm showing that as an expense of \$4.9 million. This is cost neutral because the revenue estimate that I'm offering includes increased revenue related to that. I'll address that in more detail later.

So as you can see, this totals to the \$32.4 million dollars in increases that we showed in the projected revenue matching up with that projection.

Now let's look at each one of those line items in detail. Let's begin with the \$20.3 million for education.

State Aid to Education is \$16.1 million.

That's primarily increased enrollments in the K-12 districts. In FY2019, we project enrollments to grow by almost 1,900 students. This includes an increase in students who qualify as English Language Learners which count as an additional 0.25 of a student for each one of them in the formula.

Maintenance and Repair for the Board of Regents and the Technical Institutes is \$1.0 million.

Several years ago I proposed and you adopted a plan to bring maintenance and repair budgets to 2% of the replacement value of our state buildings over the course of four years. We reached this goal in 2017 budget year, but we retreated from it to balance the budget. After updated building valuations this year, we have fallen further below that 2% mark. My recommendation for this year would be to get the Board of Regents to 1.76%, so that we don't fall even further behind. I'm also recommending funding to begin a six year plan to get the state-owned Technical Institutes' buildings to 2%.

The next line item is Board of Regents utilities.

Utility expenses at the Board of Regents are projected to increase \$894 thousand.

South Dakota Opportunity Scholarships are \$614 thousand.

The 2015 legislature increased this scholarship to \$6,500 per student with a four-year phase in. This is the fourth and final year of the phase in. This funding helps keep the scholarship competitive as an incentive for students to take rigorous high school curriculum and to stay in South Dakota for college. 4,188 recipients are projected for the coming school year.

Technical Institutes is \$558 thousand.

This corresponds to the projected enrollment growth of 160 students in FY2019.

Dual Credit Increases of \$399 thousand.

The number of students taking dual credit courses continues to increase. This funding is for an additional 4,127 credits in FY2019 over the current FY2018 numbers.

Finally, Miscellaneous Increases/Decreases of \$702 thousand.

All total to the \$20.3 million we saw in the prior chart.

Now let's look at the items which are the second item on the big chart which add up to \$11.3 million for Medical and Provider Assistance.

The second category of Medical and Provider Assistance provides mandatory Inflation of \$5.4 million.

These inflationary adjustments are required by the federal government and vary across services, such as Medicare and certain federally qualified rural health clinics.

Second, Growth and Utilization - \$4.8 million.

In FY2019, we project an additional 945 persons will enroll in Medicaid. That's 0.8% growth. I might mention during the recession, we were adding 1,000 people a month to the Medicaid rolls. So to see 945 over the course of the entire fiscal year 2019 is really very slow growth.

Rural Family Residency Track is \$180 thousand.

Last year you funded start-up costs for a rural family practice physician residency program. The program has now received initial accreditation, and this \$180 thousand funds year 1 of a 3-year implementation plan to add two residents each year for 3 years. Data shows that the majority of doctors stay to practice in the state in which they complete their residency program. With the expansion of the Medical School at South Dakota, South Dakota graduates more physicians each year than we have residency positions. When this program is complete there'll be an additional 6 residency slots in South Dakota so we'll export fewer training physicians and keep more of them in a residency in South Dakota especially in rural communities where our need is most critical.

The next item is Mental Health Court of \$139 thousand.

This is funding to the treatment portion of the Mental Health Court Pilot program in Pennington County.

Miscellaneous Increases/Decreases of \$775 thousand throughout the Departments of Social Services, Health, and Human Services.

Then finally the South Dakota Health Care Solutions Coalition.

You can see a negative number and a positive number. As stated earlier, two years ago I proposed and you adopted a plan to increase community based providers to at least 90% of costs over three years. This year my recommendation includes funding that will complete that 3 year plan. This will be funded using savings generated by the South Dakota Health Care Solutions Coalition's work to implement a federal policy for the federal government to pay the full bill when the Indian Health Service refers Medicaid patients to other providers. You can see the slide includes a savings of \$4.5 million and an expense in the same amount as these funds are used to increase rates.

So the total increase on that chart for Medical and Provider Assistance is that number you saw earlier on that other chart \$11.3 million.

Next, we'll look at the detail for the \$2.5 million under Protecting People.

This third category of Protecting People includes Correctional Healthcare expenses of \$1.3 million for costs associated with providing medical and mental health to adult offenders.

It also includes DOC Community Transition Program cost of \$1.1 million.

This program would provide community placements for parolees, to save on operational costs, such as staff and healthcare, within the prisons.

Thirdly, Mental Health Court of \$109 thousand.

This funding would establish a mental health court in Pennington County to more effectively identify and treat people with mental illness who are entering the criminal justice system.

Miscellaneous Increases/Decreases of nearly \$15 thousand.

It includes various operating expenses at adult correctional facilities, decreases within Juvenile Corrections due to the declining juvenile population, and an increase in security staff at the Community Work Centers.

The total increase related to Protecting People is \$2.6 million.

The fourth line item on the major chart, I'm also proposing \$632 thousand to address low pay for certain state employees.

As I said, I'm recommending no salary increase or market adjustment for most state employees for the 2<sup>nd</sup> year in a row, and no movement towards market value or pay for performance. We just can't afford it.

I'm also recommending no increased state support for state employee health plan costs, even as ever-rising healthcare costs will force changes to our health plan, which will impact state employees.

As we minimize that impact as much as possible, we will likely deplete our current health plan reserve and put more expense on those employees and their dependents.

For Pay Range to address Employee Market Minimum, \$632 thousand to keep some employee pay, which is already lower than market, from falling even further behind the market.

I'm going to walk you through an example so this comes down to human terms. I'm going to use a caseworker which is one of the jobs that would be affected by this. And there are about 1,500 jobs like this.

The average market salary for this job currently is \$21.70 an hour. How do we know what that is? Because we survey the market every year and we have a very comprehensive survey every four years, which we just completed. So the average wage in the market among private employers and other government employers is \$21.70. This is where we'd like the salary of our fully proficient employees to be.

The hiring point or the target minimum for a new employee in this job would be \$18.45 an hour, which is 85% of that average market wage.

However, we're currently hiring new employees for this job at \$15.00 an hour because that's all we can afford. We call this our artificial minimum or current minimum as you can see in this slide.

My proposal would allow us to move minimum pay for this job from \$15.00 an hour to \$15.87 an hour. This doesn't get us to our target minimum, but it prevents us from falling farther behind. As average market wage goes up in FY2019, we won't fall further behind.

Addressing this now, to the extent we can, will avoid more expensive problems down the road. As I said, this will affect approximately 1,500 current employees.

The fifth major expense that's actually helpful to our budget is the Federal Medical Assistance Percentage or FMAP, which is the federal government's share of each Medicaid payment, will increase for FY2019, meaning our state share of each payment will go down. Let's look at FMAP history.

This chart shows the changes of the federal and state share of Medicaid payments to providers. The federal share, shown by the red line, is called the Federal Medical Assistance Percentage or FMAP. That's the federal share.

Because the FMAP is increasing here in the last three years, our state share – the blue line - will go down by 1.13% to 43.63% of each payment.

So why is this happening? Our FMAP rate is determined by comparing South Dakota's personal income change over three years. Looking back three years, what's our personal income change as compared to the United States personal income change average over the last three years?

You'll remember that FY2011 was enhanced under the stimulus so that's why there's a big gap there. But in fiscal years 2012 through 2016, our three year trailing average of personal income was growing faster than the United States' personal income was growing in part because of high farm income. Farm income gets figured into that assessment. Since then though – since our farm income started falling – our three year average has slowed compared to the rest of the nation.

So the increased FMAP in 2019 will save state general funds in 5 different departments across the state budget. The total savings is almost \$9.8 million.

Aside from some other miscellaneous increases and decreases, the last major item I want to detail is Building South Dakota. It is shown as an expense, but its offset by an increase in general fund revenue.

Let me explain that.

Our current law includes several statutes that define how revenue flows into Building South Dakota, how those dollars are allocated among five different funds, and how those funds are spent. It has become very complicated.

A few years ago, you might remember we allocated a large sum of one-time money to Building South Dakota, with the hope that the program could sustain itself for three years. In fact, those funds have lasted for four years. Looking forward, however, the ongoing revenue sources that fund Building South Dakota are very volatile and unpredictable.

Currently, Building South Dakota receives funding in two ways:

You can see at the top. First, if the Board of Economic Development approves a reinvestment payment for a construction project over \$20 million, then the contractor's excise tax for that project flows to Building South Dakota. That varies greatly from year to year because it flows at the end of the project when the project is complete. Usually there's a delay of two or three years from the time a project is approved to when it is completed and the contractor's excise tax is transferred.

Secondly, there's a statute that states that if the budget reserve funds are over 10% of our general fund budget, and Building South Dakota funds are less than 1 percent of our general fund budget then funds are transferred from the reserves to Building South Dakota. Those conditions have never occurred.

I would like to propose that we make this much simpler. My budget would take the approximately \$3 million per year in contractor's excise tax that's currently diverted to Building South Dakota, and instead direct it back into the General Fund.

Then, I'm proposing that we allocate \$3 million in general funds – the same amount – into the funds that make up Building South Dakota. In addition, the Housing Development Authority has committed \$1.5 million in ongoing funds, for the next five years and annually, and we have also committed \$400,000 annually from the private activity bond fund. So all told, this would be a commitment of \$4.9 million in ongoing general funds that could be, in turn, spent in the general appropriations bill for Building South Dakota.

This proposal would eliminate the 5% stream of dollars that's currently allocated to the REDI fund, and would allocate the dollars instead to the four remaining funds.

Housing Opportunity: \$1.9 million

Local Infrastructure: \$1.5 million

Workforce Education: \$1.125 million

Economic Development Partnership: \$375,000

I believe that allocation closely mirrors the current allocation, and the level of utilization each program has seen, but I'm certainly open to rebalancing that through the appropriations process.

If we make this change, these four funds will exist in the General Appropriations Act each year, rather than relying on a complicated and unreliable side-statute. This will make it easier for legislators to weigh the relative benefits of each fund and to allocate future revenue increases as our needs change.

If my proposed legislation does not pass, the \$3 million in contractor's excise tax would continue to be withheld from the General Fund for Building South Dakota. That's why this proposal is revenue neutral – we're adding \$3 million to the General Fund and putting \$3 million of spending in the General Bill from those dollars along with the \$1.5 million and the \$400,000 from the other two sources. Unless this program is abolished entirely, there is no way to redirect those funds elsewhere because they won't exist in the General Bill.

This slide once again summarizes the major spending changes in the budget I am proposing today. The net spending increase of \$32.4 million mirrors the increase in projected revenue for FY2019.

Now that we have discussed the proposed FY2019 budget, let's go back to 2018 the year we're in right now. We've got seven months to go in the year but we know we're going to have a revenue shortage if things continue.

And remember, as described earlier, our most recent projections today are that our revenue will be \$20.3 million less than our adopted expenditures. That's the adopted expenditures and revenue we adopted last March.

In addition to \$20.3m revenue shortfall, we also have \$10.4 million in additional FY2018 expenses as well. Let's look at those increased expenses.

State Aid to Education is \$9.0 million. This increase is due to the same factors we mentioned earlier.

First, number of student enrollments, compared to what was estimated is about 450 more students.

Second, the number of English Language Learners is up. We pay an extra 25% for students who are English Language Learners.



Third, Dual Credits. For FY2018, we are projecting 2,882 more credits than budgeted.

Fourth, property valuations are a little lower than projected, which reduces local property tax collections and increases the state share.

Utility Rate and Food Service Adjustments is \$617 thousand. Increases of \$617 thousand in general funds are due to increased costs and usage in the current year utility and food service budgets in various agencies.

The Technical Schools are seeing also increased enrollment. They're seeing 103 more students enrolled than previously budgeted. That's costing us \$358 thousand more.

Miscellaneous Increases of \$394 thousand. This includes \$320 thousand for the Obligation Recovery Center for recovery fees, which is a net impact of \$0 to the general fund because it means we are also collecting more debt than we anticipated. Collections for FY2018 are projected to increase \$1.4 million over budgeted levels. Most of these funds do not go to the general fund, but instead to the court system, municipalities, and counties. But it's an indicator of a good thing because we're collecting more debts than we would've otherwise anticipated.

Then I'm also recommending \$3 million in emergency special appropriations for FY2018. Adding in these appropriations brings our total shortfall to \$33.7 million. Let's take a closer look at the special appropriations in detail.

First, Healthcare Recruitment Assistance Program is almost \$838 thousand.

This funding will pay for healthcare professionals such as physicians, dentists, nurse practitioners, pharmacists, and so on who have met their 3 year commitment to practice in rural areas and now we owe them a reimbursement of their tuition.

Second, Wildland Fire Suppression Fund is \$766 thousand.

This is to backfill the fire fund for wildland fires that have taken place in the past year.

Aviation Support Facility is \$500 thousand.

This will provide a portion of the funding needed for year 1 of 3 years to pay for an Aviation Support Facility for the Army National Guard at the Rapid City Regional Airport. We were able to move up the federal project list. Total funding needed from state sources will be \$5 million over 3 years with an additional \$15 million from the federal government.

The next item is Tax Refunds for the Elderly.

You've seen before there is an annual appropriation that pays for refunds of sales tax or property taxes for elderly and disabled persons that meet low income guidelines.

Extraordinary Litigation Fund is \$424 thousand.

This is to backfill the Extraordinary Litigation Fund for litigation expenses not covered by the PEPL fund - the Public Entity Pool for Liability.

In total, as you can see, this is just under the \$3 million of Special Appropriations.

So here again is the total shortfall of \$33.7 million for the year we're in right now. Here is how I am proposing to fill it.

First, we're going to reduce expenses by \$16 million. Let's look at what those reductions are:

Department of Social Services Utilization is \$5.9 million.

Again, I remarked how slowly our enrollment growth is as compared to what it was during the recession. So we're going to reduce the number of people we project eligible for Medicaid services to follow the trend we've been seeing.

Second, the Department of Social Services Program Funds is \$5.8 million.

This includes using \$3.0 million in Temporary Assistance for Needy Families funds, \$2.0 million of prescription drug rebate funds, and \$800 thousand in SNAP funds - Supplemental Nutrition Assistance Program, formerly food stamps.

From the Department of Human Services, \$3.6 million.

We're projecting lower utilization again much like the Medicaid enrollment that impacts Human Services, reductions in Long Term Services and Supports and Developmental Disabilities based on current projections, and also a reduction at the South Dakota Development Center in Redfield due to our initiative to right-size that program.

Next, the DOC Juvenile Utilization is down due to the declining juvenile population and the upcoming sale of STAR Academy. This assumes we will get the STAR Academy sold and get over half a million of expense off the books – annual expense.

From Public Safety State Radio, a \$100 thousand reduction based on current expenses.

Fire Premium Refund Update. \$20 thousand of adjustment to the Fire Premium Refund continuous appropriation based on actual figures.

You can see all those reductions total \$16 million and that will cover part of the gap.

The other part of the gap is the use of one-time cash resources so we'll look at that next. The \$17.7 million is made up by quite a few things.

The Budget Reserve to 10% is \$7.2 million.

I propose to transfer \$7.2 million from the budget reserve. That will still keep our reserve at 10% but uses the excess – that \$7.2 million and that will be used to cover most of our FY2018 shortfall in state aid to education.

From Health and Education Facilities Authority, \$2.5 million to cover the rest of the shortfall in education funding and to cover our rural healthcare recruitment incentive obligations because that authority has to spend money on education and healthcare.

The rest of this list includes cash resources within the various departments, which you can see on the slide.

Department of Human Services Homemaker Fees: \$2.0 million.

Petroleum Release Compensation Fund: \$1.3 million.

Department of Ed Workforce Education Fund: \$793 thousand.

Department of Human Services Telecommunications Relay Services: \$750 thousand.

Department of Human Services Prescription Drug Fund: \$750 thousand.

Department of Education E-Rate Fund: \$500 thousand.

Video Lottery Fund: \$500 thousand.

Court Automation Fund: \$500 thousand.

Private Activity Bond Fee: \$481 thousand.

Finance and Management Budgetary Accounting Fund: \$261 thousand.

Veterans' Home Operating Fund: \$120 thousand.

All total \$17.7 million.

So those two items cover the shortfall of \$33.7 million in the current fiscal year. Again, proposing reducing expenses by approximately \$16.0 million and utilizing \$17.7 million of cash resources.

And to put this in perspective, this \$33.7 million is about 2% of our general fund budget and about 7/10 of 1% of our total budget. So it's a hole, but put it in perspective another way. Moody's reported when the fiscal year began about a dozen states didn't even have a budget yet. Montana just finished their special session to fix their budget hole. Oklahoma had an eight week special session that ended up in failure and they're probably going to have to get back together to fill a \$250 million budget hole.

So all things considered, I think we're in relatively good shape. I wish we had better revenue growth. I wish we didn't have these unforeseen expenses but again all things considered, we're in pretty good shape.

So here's a final look at FY2018 and FY2019.

I'm proposing a revised budget in 2018 of \$4.6 billion and recommending \$4.7 billion in total spending for 2019.

The recommended FTE for FY2019 are 13,905.9.

Full time equivalent employees in agencies under my direct control are still 116 fewer than when I took office in 2011.

Both years are honestly balanced, with ongoing expenses for FY2019 fully supported by only ongoing revenue. And there again is a distinction from some other states. In Illinois, they are very clearly funding ongoing expenses with one-time revenue and much of it through borrowing. That's not something we're doing.

We're honestly balancing our budget with ongoing revenue only being used for ongoing expenses.

In closing, South Dakota is working. Working better than many other states.

We can proudly say that we've structurally balanced our budget, honestly, without gimmicks. This is our 129th year of balanced budget which is honestly balanced.

We have prudently maintained a 10% reserve.

We have one of the strongest pension plans in the nation. S&P just released a report a couple of months ago that identified South Dakota among the top 170 plans in the nation. We're 1 of 5 they held up as examples.

We have placed improvements in our financial practice improvements into statute to help guide our state for the long-term. After we're gone, others in our place will follow these statutes hopefully.

And all these practices are paying dividends. South Dakota holds the top credit rating from all 3 major credit rating agencies.

I'm very proud of the achievements on this slide. They aren't my achievements. They aren't really our achievements. They reflect the discipline and maturity that you have shown as legislators, and that many past governors and legislators have shown. We should never take that for granted. Every year our continued prosperity is never guaranteed. We must be ever watchful and not take that for granted. Many other states find themselves in dire straits today because they failed to maintain that discipline that I'm proud South Dakota has historically maintained.

I hope you are proud of these accomplishments also. I look forward to working with you together this year to help South Dakota maintain a sound financial footing. Thank you very much for your attention today.